MAR 10 1976
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1334

W & W FERTILIZER CORPORATION,
Petitioner

v.

THE UNITED STATES OF AMERICA,
Respondent

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF CLAIMS

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PETITION FOR A WRIT OF CERTIORARI
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The Petitioner, W & W Fertilizer Corporation, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of The United States Court of Claims entered in this proceeding on December 17, 1975. References are to the Appendix included as a part of this Petition.

OPINION BELOW

The opinion of The United States Court of Claims, Docket No. 17-74, has not yet been officially reported. An unofficial report is found at 76-1 USTC ¶9130. A copy of the opinion is appended to this petition as Appendix A.

JURISDICTION

The judgment of The United States Court of Claims was

made and entered on December 17, 1975. This Petition for Writ of Certiorari was filed within ninety (90) days of that date. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTION PRESENTED

Where an individual establishes a revocable inter vivos trust, retaining all ownership rights therein, both in fact and in law, and transfers to that trust stock of an electing "small business corporation", will the stock in said corporation in the hands of the trust be deemed to be held by a person other than the individual, so as to result in a termination of the corporation's election pursuant to Section 1372 of the Internal Revenue Code.

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The question presented in these proceedings involves Sections 1371(a) and 1372(e)(3) of the Internal Revenue Code of 1954 (26 U.S.C. 1371(a), 1372(e)(3)) and Treasury Regulations, Sections 1.1371-1(d)(1), 1.1371-1(e) and 1.1372-4(b)(3) (26 CFR 1.1371-1(d)(1), 1.1371-1(e), 1.1372-4(b)(3)). These statutory provisions and regulations are set forth in Appendix B hereto.

STATEMENT OF THE CASE

This is a suit arising under the Internal Revenue Code of 1954 (hereinafter referred to as the "Internal Revenue Code"). The facts involved are as follows:

The Petitioner was incorporated under the laws of the State of Florida on March 20, 1907. On or about April 27, 1965, the Petitioner elected to be taxed as a "small business corporation" pursuant to Section 1371 et. seq. of the Internal Revenue Code (hereinafter referred to as "Subchapter S"). The election was effective for Petitioner's taxable year ending March 31, 1966, and subsequent years.

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At the time of making the election, the Petitioner had only two shareholders: Lemuel P. Woods, owning 1,415 shares (46.6% of the total outstanding); and, Fred J. Woods, his brother, owning 1,624 shares (53.4% of the total outstanding), both of whom consented to the election.

On February 25, 1970, Lemuel P. Woods established the Lemuel P. Woods Revocable Trust (hereinafter referred to as the "Woods Trust"). Among the assets transferred to the Woods Trust on that date were all of the shares of stock in the Petitioner owned by Lemuel P. Woods.

The Woods Trust was a revocable inter vivos trust, all of the income of which was taxable to and reported for federal income tax purposes by Lemuel Woods. Lemuel Woods reserved to himself the right to revoke the Woods Trust at any time and to revest title to the assets held by the Woods Trust in himself. The Exchange National Bank of Tampa (hereinafter referred to as the "Exchange Bank") was designated a co-trustee, along with Julia Woods, Lemuel Woods' wife (hereinafter referred to as "Mrs. Woods"), who was designated a co-trustee for the sole purpose of consulting with the Exchange Bank with respect to the investment of trust assets.

Prior to the establishment of the Woods Trust, Lemuel Woods had been advised and assured by the Exchange Bank that he would retain absolute control during his lifetime over all assets transferred to the Woods Trust.

Lemuel Woods was the sole income beneficiary of the Woods Trust. The Trustees have never made any income distribution or payment from the Woods Trust except as directed by Lemuel Woods.

At the time of the establishment of the Woods Trust, Fred J. Woods, brother of Mr. Woods, and members of his family owned 278,416 shares, or 6.8%, of the outstanding stock of the Exchange Bank Corporation, the bank holding company which wholly owned the Exchange Bank. The shares owned by the

Woods family constituted the third largest block of common stock owned by any single family. In addition, Fred J. Woods was Chairman of the Board of Directors of both the Exchange Bank Corporation and the Exchange Bank. He was also President of the Exchange Bank Corporation and had served as a Director of the Exchange Bank since January 10, 1939.

The Woods family was one of the three most influential families in the affairs of the Exchange Bank, and one or more members of the Woods family were in contact with officers of the Exchange Bank on a daily basis. The officers of the Exchange Bank, including the officers responsible for the administration of the Woods Trust, courted the favor of the members of the Woods family and accorded them preferential treatment in all their dealings with the Exchange Bank, including the administration of the Woods Trust.

The Exchange Bank did not make any investment or other substantive decision with respect to the administration of the Woods Trust without first consulting with and obtaining the approval of Lemuel Woods. The Exchange Bank promptly, unquestioningly, and faithfully executed any and all instructions issued by Lemuel Woods with respect to the administration of the Woods Trust.

As a result, Mr. Woods at all times retained and exercised absolute control over the assets composing the Woods Trust, including the stock in Petitioner.

The Petitioner timely filed its tax return for the taxable year ended March 31, 1970 on Form 1120-S. Subsequently, on or about April 13, 1971, an amended corporate income tax return, Form 1120-X, accompanied by an amended Form 1120, was filed by the Petitioner with respect to the same taxable year.

The Form 1120-X and the amended Form 1120 with respect to the taxable year ended March 31, 1970, were prepared and filed on the basis that the Subchapter S election of the Petitioner

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had terminated, resulting in a corporate income tax liability for that taxable year. The tax was paid on or about April 15, 1971, and interest thereon was paid in two later installments.

The amended returns were accompanied by a cover letter stating that their filing and the payment of additional taxes in connection therewith did not constitute and should not be deemed to constitute an admission by the Petitioner of a termination of its Subchapter S election.

On April 13, 1973, Petitioner filed a claim for refund in which it alleged, and has maintained ever since, that the Woods Trust was a nullity under applicable principles of taxation and that the Petitioner had at no time a shareholder other than an individual. On January 17, 1974, the claim for refund was officially disallowed in full.

On January 11, 1974, Petitioner brought suit in The United States Court of Claims, Washington, D.C., pursuant to 28 U.S.C., Section 1491. Following filing of joint motions for summary judgment, presentation of briefs and oral argument, the Court granted Respondent's motion for summary judgment, denied Petitioner's cross motion for summary judgment, and dismissed the Petition.

REASONS FOR GRANTING THE WRIT

The United States Court of Claims has decided a question of major significance regarding the ability of small businessmen to select a form of business organization without the necessity of taking into account major differences in federal income tax consequences. In reaching its decision, the Court of Claims repudiated traditional principles of federal tax law and adopted positions inconsistent and in conflict with decisions both of this Court and other courts and rulings of the Internal Revenue Service.

In particular, the decision below should be reviewed for the following reasons:

1. The decision provides that the doctrine of substance over form and the traditional principles of federal taxation respecting trusts, forcibly enunciated by this Court in *Helvering v. Clifford*, 309 U.S. 331 (1940), are inapplicable in determining who is a shareholder in a Subchapter S corporation.

2. The decision provides that a revocable inter vivos trust is to be accorded a treatment in the context of Subchapter S which is different from that accorded such a trust in other areas of the Internal Revenue Code.

3. The decision is in conflict with decisions of this Court and other federal courts and the rulings of the Internal Revenue Service.

In 1958, Congress enacted Subchapter S of the Internal Revenue Code for the purpose of affording tax relief to small businesses by eliminating federal income tax consequences as a factor in the selection of forms of business organization. With few exceptions, Congress designed Subchapter S to make the same tax treatment previously available only to proprietorships and partnerships also available to those small corporate business structures economically similar to proprietorships and partnerships. To this end, Subchapter S provides a qualified "small business corporation" the option of eliminating federal income tax at the corporate level, thereby avoiding double taxation of business income.

To restrict the availability of the relief afforded by Subchapter S, Congress provided that a qualifying "small business corporation" may not ". . . have as a shareholder a person (other than an estate) who is not an individual; . . .". The question before the Court of Claims in this proceeding was whether the Woods Trust was for federal income tax purposes an entity separate and distinct from its grantor so that for purposes of Section 1371(a) of the Internal Revenue Code the Woods Trust and not Lemuel Woods was the shareholder in Petitioner.

Renunciation of Substance over Form and Other Traditional Doctrines

In determining whether Lemuel Woods or the Woods Trust should be treated as the shareholder of Petitioner for Subchapter S purposes, the Court of Claims declined to employ the doctrine of substance over form and other traditional analytic principles. Instead, it focused on the admitted, but inapposite, fact that the Woods Trust was a viable legal entity under the laws of the State of Florida, and ignored that under state law and the terms of the trust agreement Lemuel Woods was the beneficial owner of the trust assets.

The Court of Claims failed to recognize that although a trust may exist for state law purposes, that fact is irrelevant to a determination whether its existence will be recognized for federal income tax purposes. *Irvine K. Furman*, 45 T.C. 360 (1966), *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967). As pointed out by this Court in *Helvering v. Clifford, supra*, whether a trust is to be recognized as an entity for federal income tax purposes depends on the nature and degree of control over the trust assets and their administration retained by the grantor. As stated by this Court therein:

> "Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which invented genius may construct as a refuge from surtaxes should not obscure the basic issue. *That issue is whether the grantor after the trust has been established may still be treated . . . as the owner of the corpus. . .*" (Emphasis Added) 309 U.S. at 334-335.

The erroneous preoccupation of the Court of Claims with the admitted existence of the trust for state law purposes was central to its decision and led it to disregard traditional principles of federal tax law in resolving the question before it. An application of these principles to the facts of this case compel the conclusion that for federal income tax purposes, including Subchapter S, Lemuel Woods was at all times the owner of the stock of Petitioner.

The Petitioner submits that no doctrine is more fundamental to the consistent, evenhanded and uniform administration of the federal tax laws than that of "substance prevails over form". By its decision, the Court of Claims ordains that this doctrine and the teachings of *Helvering v. Clifford, supra*, designed to disclose who is to be treated as the owner of trust assets for federal tax purposes, are to be laid aside in determining who is a shareholder of a Subchapter S corporation. The Petitioner respectfully submits that this position is palpably untenable and contrary to all authorities. *Fulk & Needham, Inc. v. United States*, 288 F.Supp. 39 (M.D.N.C. 1968), *aff'd*, 411 F.2d 1403 (4th Cir. 1969); *Old Virginia Brick Company v. Commissioner*, 367 F.2d 276 (4th Cir. 1966).

There is nothing in the language of the statute or the legislative history of Subchapter S which requires the abandonment of these principles. The issue presented in these proceedings was not addressed by the Congress at the time of the enactment of Subchapter S. Certainly, there is no indication in the legislative history that the provisions of Subchapter S are to be insulated from traditional federal tax principles and analysis.

Inconsistent Treatment of Revocable Inter Vivos Trust

The decision of the Court of Claims also introduces an inconsistency in the treatment of revocable inter vivos trusts under the Internal Revenue Code. To accord the Woods Trust treatment consistent with that accorded it for purposes of other provisions of the Internal Revenue Code, Lemuel Woods must be treated as the owner of the stock of Petitioner for Subchapter S purposes.

Under Subpart E of Subchapter J of the Internal Revenue Code (commonly referred to as the "grantor trust" rules), where a grantor such as Lemuel Woods retains the power to control the administration and beneficial enjoyment of assets placed in trust and to revoke the trust, the trust is not accorded

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independent significance for federal income tax purposes. Instead, the grantor is treated as the owner of the assets comprising the trust. The Woods Trust was such a trust. Accordingly, pursuant to the grantor trust rules, Lemuel Woods is treated as the owner of the assets held by the Trust and taxable on the income derived therefrom.

Similar treatment obtains for purposes of Section 453(d) of the Internal Revenue Code. In that context, the question arises whether the transfer of an installment obligation by an individual to his trust constitutes a disposition of the installment obligation which would result under Section 453(d) in the immediate recognition of the gain or loss included in the unpaid balance of the obligation. Even though under state law the transfer constitutes a valid, enforcible transfer in trust, the Internal Revenue Service has ruled that such a transfer does not constitute a taxable Section 453(d) disposition. Rev. Rul. 74-613, 1974-2 C.B. 153. In this situation, the revocable inter vivos trust is again denied tax recognition independent of the grantor because, under the grantor trust rules, the grantor remains the owner of the trust assets for federal income tax purposes.

These same principles also apply in the estate tax area. Indeed, in Treasury Regulations, Section 20.2042-1(c)(6), relating to the estate taxation of corporate-owned life insurance on the life of a majority shareholder, the Internal Revenue Service uses the grantor trust rules as a sword to reach exactly the same result Petitioner urges herein. These Regulations provide that a decedent is considered to be the owner of stock held at the time of his death by any trust in respect of which the decedent is treated as the owner of the trust assets under the grantor trust rules.

In short, for other federal tax purposes, Lemuel Woods is treated as the owner of the stock in Petitioner held by the Woods Trust. As this Court has pointed out, it is essential that the Internal Revenue Code be interpreted so as to give a uniform application to the nation-wide system of taxation.

Burnet v. Harmel, 287 U.S. 103, 110 (1932). The Petitioner respectfully submits that the Court of Claims erred in according the Woods Trust different treatment for Subchapter S purposes than it receives for other purposes of the internal revenue laws.

Decision Contrary to Other Decisions and Rulings

The decision of the Court of Claims is also inconsistent with and contrary to analogous decisions of other courts and rulings of the Internal Revenue Service. For example, it has been held in all decisions on the subject that beneficial ownership rather than bare legal title is dispositive in determining who is a shareholder for purposes of Subchapter S. See, e.g. *Alfred N. Hoffman*, 47 T.C. 218 (1966), *aff'd*, 391 F.2d 930 (5th Cir. 1968); *Kean v. Commissioner*, 51 T.C. 337 (1968), *aff'd*, 469 F.2d 1183 (9th Cir. 1972); *William B. Wilson*, 34 T.C.M. 463 (1975); and *Lafayette Distributors, Inc. v. United States*, 397 F.Supp. 719 (W.D.La. 1975). The decision of the Court of Claims is clearly contrary to the holdings of these cases.

Likewise, the decision of the Court of Claims is irreconcilable with the many decisions holding that substance rather than form controls in determining who is a shareholder for Subchapter S purposes. See, e.g. *Fulk & Needham, Inc. v. U.S.*, 288 F.Supp. 39 (M.D.N.C. 1968), *aff'd*, 411 F.2d 1403 (4th Cir. 1969); *Old Virginia Brick Company v. Commissioner*, 367 F.2d 276 (4th Cir. 1966). The decision of the Court of Claims simply cannot be squared with the following pertinent language appearing in a footnote to the opinion of the Fourth Circuit Court of Appeals in *Fulk & Needham, Inc., supra:*

> "[Taxpayer] draws into question the validity of Treasury Regulation § 1.1371-1(a)(2) promulgated to implement § 1371(a)(2) of the statute. The Regulation purports broadly to disqualify any corporation in which a formal trust is a shareholder, regardless of the substance or nature of the trust. In particular, it provides that a corporation in which a voting trust or "Clifford" trust is a shareholder does not qualify under Subchapter S. Taxpayer points out that the

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> Regulation was in part invalidated in *A & N Furniture Co. v. U.S.* [citations omitted] where the court held that a voting trust did not disqualify the electing corporation.
>
> *The portion of the Regulation condemned in that case [Regulation § 1.1371-1(e)] may well be open to challenge as conflicting with the principle of substance over form. Likewise, the portion of the Regulation which undertakes to disqualify a Clifford trust (where the form of a trust is employed but the grantor retains control and is taxed as the true owner) may be open to attack."* 411 F.2d at 1407, ftn. 4 (emphasis supplied)

Despite the Court of Claims' attempts to distinguish them, the Petitioner submits that the decision is also inconsistent with and contrary to the analogous decisions in *A & N Furniture & Appliance Co. v. U.S.*, 271 F.Supp. 40 (S.D.Ohio 1967) and *Lafayette Distributors, Inc. v. U.S.*, 397 F.Supp. 719 (W.D.La. 1975), holding that a voting trust is not a shareholder other than an individual for Subchapter S purposes. No less than a revocable inter vivos trust, a voting trust is a valid trust under state law, according powers and duties to the trustee and establishing the trustee as the record holder of stock subject to the trust. Certainly it involves no more or less a nominee arrangement than that existing between a grantor and his revocable inter vivos trust.

In its administration of Subchapter S, the Internal Revenue Service itself has not relied on so superficial an interpretation of Section 1371(a)(2) as that adopted by the Court of Claims in its decision. Nowhere in the statutory language of Subchapter S is there express authority for a nominee, agent, guardian or custodian to be a qualifying shareholder of a Subchapter S corporation. Yet, the regulations make it clear that persons for whom stock in a Subchapter S corporation is held by any of these named representatives will be considered as shareholders of the corporations. Treasury Regulations, Section 1.1371-1(d)(1).

Additionally, the Internal Revenue Service acknowledges that for purposes of Section 1371(a), requiring that shareholders must consent to a Subchapter S election, beneficial ownership and not record ownership is determinative of who is a shareholder. Rev. Rul. 70-615, 1970-2 C.B. 169. Interestingly, in acknowledging the beneficial ownership test, the Internal Revenue Service spoke in terms of the entirety of Subchapter S, rather than simply the consent provisions:

> "Section 1.1371-1(d)(1) of the Income Tax Regulations provides, in part, that ordinarily the person who would have to include in gross income dividends distributed with respect to the stock of a small business corporation are considered to be the shareholders of the corporation.
>
> *Thus, for purposes of determining who is a shareholder under the provisions of Subchapter S of the Code, beneficial ownership of the stock rather than technical legal title is controlling.*" 1970-2 C.B. at 169. (Emphasis supplied).

The Petitioner submits that the test for determining shareholder status cannot, as decided by the Court of Claims, be different for purposes of consecutive provisions of the Internal Revenue Code, integrated in both language and purpose.

It is respectfully submitted that the decision of the Court of Claims cannot be reconciled with the great body of authority concerning Subchapter S, including the administrative rulings and practices of the Internal Revenue Service. In short, the decision constitutes an unwarranted departure from analogous, well-reasoned and correct precedent.

CONCLUSION

For these reasons, and because the decision of the Court of Claims sharply curtails the substantial benefits which Congress intended to accord small businessmen in the enactment of Subchapter S, the Petitioner respectfully submits that this Petition for a Writ of Certiorari should be granted.

s/s SHERWIN P. SIMMONS

SHERWIN P. SIMMONS